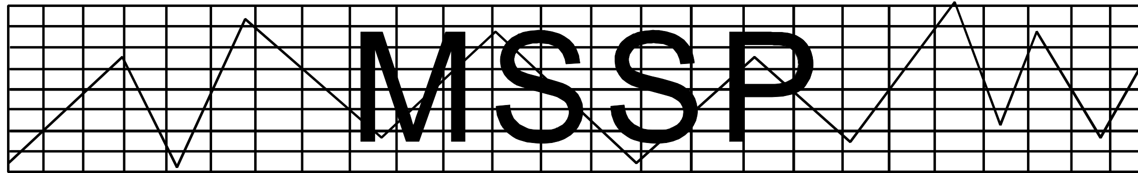

Market Segment Specialization Program

Shareholder Loans

The taxpayer names and addresses shown in this publication are hypothetical. They were chosen at random from a list of names of American colleges and universities as shown in *Webster's Dictionary* or from a list of names of counties in the United States as listed in the *United States Government Printing Office Style Manual*.

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Shareholder Loan Audit Techniques Guide

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Introduction

Scope: A number of Code sections pertain to loans. The various Code sections provide guidance in addressing arm's length concerns, the timing of interest recognition, and the allocation of interest and principal. This guide addresses only issues regarding loans to shareholders.

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Chapter 1

Bona Fide Debt Versus Non Bona Fide Debt

BONA FIDE DEBT VERSUS NON BONA FIDE DEBT

In General

The first question to ask when examining an amount classified as a shareholder loan is whether there is a bona fide debt. The primary determination as to whether or not the debt is bona fide hinges on a key question: When the loan was made, was there a genuine intent that the borrowed funds would be repaid?

Courts have looked not to mere labels or to the parties' own testimony, but to the objective facts and circumstances surrounding a transaction. An example is seen in ***Baird v. Commissioner***, 25 T.C. 387, 395 (1955), where the court stated: "The treatment of petitioners' withdrawals on the corporate books as 'Notes Receivable' is not controlling, since it is well settled that book entries may not be used to conceal realities as a means of relieving the taxpayer from liability for income taxes."

Over many years, a set of common law factors has evolved which, when viewed as a whole, generally lead to a proper conclusion. On the other hand, in ***Miller v. Commissioner***, T.C.M. 1980-445, the court stated: "The factual patterns in this instant case do not clearly compel any particular conclusion." In ***Miller***, the court held that the distributions in question represented bona fide debt, but it is quite evident that the determination was anything but an exact science. Each case stands on its own merits and must be evaluated on its facts and circumstances. It should also be emphasized that no single factor is determinative. The factors are discussed below. Furthermore, because of the inherent difficulty in determining the proper result in these cases, the examiner may wish to contact their district counsel office for assistance.

Key Determining Factors

All scenarios below assume that the distribution in question is being treated as a loan to the shareholder.

1. The extent to which the shareholder controls the corporation.

   If a shareholder controls the majority of a corporation's stock, he or she can exercise direct control over the corporation's earnings and profits.

That condition tends to suggest a constructive dividend. For example, if shareholder controls exactly 50 percent of a corporation's stock, and if an equal distribution is not made to the other 50 percent shareholder, and the other shareholder did not object to the loan treatment of the distribution, that suggests that a loan was made. The probability of an arm's length transaction is far greater if the shareholder receiving the loan, does not own a majority (directly or through attribution) of the corporate stock.

However, the critical element is the extent to which the shareholder is able to control the affairs of the corporation, irrespective of whether that control derives from stock ownership, family relationship, or some other source. In some situations, a shareholder may exert nearly total control of a corporation but directly own only a small percentage of the stock. **See** ***Baird v. Commissioner***, 25 T.C. 387 (1955)

2. Whether security was given.

In most circumstances, the failure to provide security may be an indication that a distribution was intended. However, the court noted in ***Shea v. United States***, 83-1 USTC ¶9115 (N.D. Ala. 1982), that where a corporation's articles of incorporation provide that the corporation has a lien on its shares of stock for any debt or liability incurred to it by a stockholder, the fact that no security is given for the advances made to a shareholder does not preclude a finding that the advances constituted bona fide loans, even though the shareholders were unaware of the provision in the articles at the time the advances were made.

3. Is the shareholder in a position to repay the loan?

The shareholder's salary, other income, and net worth are relevant in determining the shareholder's ability to repay. If the shareholder is in a position to repay the advances based on his current financial status, that supports a bona fide loan. In ***Smith v. Commissioner***, T.C.M. 1980-15, however, the mere fact that the shareholder had a good credit rating was not conclusive to establish that the shareholder was in a position to repay the advances.

4. Adequate earnings and profits.

If there are no current or accumulated earnings and profits (E&P) at the time of distribution, the distribution will not be treated as a constructive dividend under IRC section 301. **See** IRC section 316 (Dividend Defined). That does not mean that because a corporation has a deficit or no E&P, a distribution is a bona fide loan. It simply means that the distribution cannot be classified as a dividend, but could be a return of capital or capital gain. **See** IRC sections 301(c)(2), (3). Thus, before an agent challenges the validity of a loan, the issue of adequate E&P must be considered.

5. Certificate of indebtedness is given to the corporation.

The fact that no note of indebtedness was issued to the corporation is not a determinative factor. There are numerous court cases where no note was issued for advances, but, based on other factors, the advances were accepted as bona fide loans.

The lack of a certificate of indebtedness has been considered an indication of a constructive dividend. In ***Smith***, ***supra***, the shareholder made an advance to the corporation and received a promissory note or a certificate of indebtedness, but no note was given when the corporation made an advance to the shareholder. That circumstance weighed strongly in favor of constructive dividend treatment. there a repayment schedule or an attempt to repay?

6. Is there a repayment schedule or an attempt to repay?

Even if the repayments are made, if the amount advanced continues to increase over a sustained period of years, that would tend to support constructive dividend treatment. Repayments made either by direct payments or by such means as bonus credits would support a debtor-creditor relationship. If a regular repayment schedule is being followed for the payment of interest and reduction of principal, that would be a factor favoring a bona fide loan.

7. Is there a set maturity date?

Generally, a fixed maturity date is significant, ***United States v. Title Guarantee & Trust Co***., 133 F.2d 990 (6th Cir. 1943). However, even in the absence of a fixed maturity date, a loan will be respected as such if it is repaid within a reasonable period of time. In ***Shea***, ***supra*** there was no set maturity date, but systematic payroll deductions were being made that would have paid the advances off in a few years. In that case, the lack of a set maturity date was not held against the shareholder. An examination may reveal that a shareholder annually reissued a term note for the previous amount owed, plus some or all of the accrued interest. In that situation, a pattern of setting a maturity date, but never repaying the loan often indicates constructive dividend treatment.

8. Whether the corporation charges interest.

The failure to charge interest may indicate that those advances are constructive dividends. However, when no interest is charged in the closely held context, section 7872 may apply. In ***Shea***, ***supra***, the corporation had an across-the-board policy for all employees that no interest would be charged on outstanding loans. At the other end of the spectrum is ***Thielking v. Commissioner***, T.C.M. 1987-227. The court concluded that petitioner caused a journal entry to be made on the books of the corporation reflecting accrued interest on the net withdrawals he made

from the corporation with a corresponding credit to interest income of the corporation each year. Although the facts seem to strongly indicate a bona fide debt, the court examined the shareholder's actual intent to repay the advances. The court held that the advances were constructive dividends and not bona fide debt. Generally, a failure to charge interest supports constructive dividend treatment or imputed dividends under IRC section 7872.

9. Whether the corporation has made systematic efforts to obtain repayment.

   What action has the corporation taken to obtain repayment? The shareholder's failure to make payments, or only minimal payments, indicates a constructive dividend, particularly if the corporation is not taking steps to enforce the loan. If a closely held corporation does not apply pressure on a borrowing shareholder for repayment, the transaction may not be at arm’s length. However, the fact that a shareholder is making reasonable payments is not one that is considered in this analysis.

10. Magnitude of the advances.

    Another indication of a constructive dividend is if a corporation makes large advances to a controlling shareholder, and the shareholder's ability to repay is essentially contingent on future events.

11. Whether a ceiling exists to limit the amount the corporation can advance.

    A numerical ceiling on the amount that can be advanced to a shareholder would tend to support bona fide debt. The courts have also held that if a corporation is required to obtain the consent of an equal controlling block of stock to make an advance, that action imposes a de facto ceiling on the amounts which can be advanced. This is seldom a key factor, but advances in cases of a ceiling may be treated as constructive dividends in some instances.

12. Dividend history of the corporation.

    Adequate earnings and profits with respect to the advances made, coupled with no history of paying dividends, favors constructive dividend treatment.

It cannot be emphasized enough that the above-listed factors must be viewed as a whole. Any factor considered on its own will probably not be determinative. The purpose for analyzing the above-stated factors is to determine the parties' intent at the time of the distribution. In addition, this list of factors is not all-inclusive. Any facts that may provide insight into the parties’ intent at the time of the distribution should be developed.

Taxpayer May Be Held to Its Reporting Position

A taxpayer that has consistently reported an item as debt (or equity), on its tax return, and, if applicable, for financial and regulatory purposes, can be held to that reporting position. ***Taiyo Hawaii Co. v. Commissioner***, 108 T.C. 590 (1997).

According to the Supreme Court ***in Commissioner v. National Alfalfa Dehydrating & Milling Co.***, 417 U.S. 134, 149 (1974): While a taxpayer is free to organize his affairs as he chooses, once having done so, he must accept the tax and may not enjoy the benefit of some other route he might have chosen to follow but did not. [Citations omitted.]

In some rare cases courts have permitted taxpayers to recharacterize a transaction to reflect its substance in situations where its "tax reporting and other actions have shown an honest and consistent respect for***the substance of ***(a transaction)." ***Federal Nat'l Mortgage Ass'n v. Commissioner***, 90 T.C. 405, 426 (1988) (citing ***Illinois Power Co. v. Commissioner***, 87 T.C. 1417, 1430 (1986)), ***aff'd***, 896 F.2d 580 (D.C. Cir. 1990). However, if financial reporting and other actions are not consistent with what the taxpayer contends is the substance of the transaction, then that recharacterization will not be respected. ***Comdisco, Inc. v. United States***, 756 F.2d 569, 578 (7th Cir. 1985); ***Estate of Weinert v. Commissioner***, 294 F.2d 750, 755 (5th Cir. 1961), ***rev'g and remanding*** 31 T.C. 918 (1959); ***Federal Nat'l Mortgage Ass'n, supra*** at 426. Instead, the taxpayer will be held to its initial reporting position.

Equitable Estoppel and Duty of Consistency

A taxpayer that has treated an item in a certain manner for one taxable year may, after the period of limitations for that year has expired, attempt to treat the item in an inconsistent manner. Two related judicial doctrines, equitable estoppel and duty of consistency (sometimes referred to as quasi-estoppel), are available to counter a change in position, including a change that is tax-motivated. If not for these doctrines, a shareholder could classify advances as loans until the statute expired, and then, to achieve more favorable tax treatment, claim that the loans should have been classified as dividends. No assessment would be possible, unless some exception to the normal 3-year period of 1imitations applied. IRC section 6501(e) (It is a 6-year period of limitations in cases of substantial omission of items).

The elements usually required for application of the doctrine of equitable estoppel are: (1) conduct amounting to a misrepresentation or concealment of a material fact; (2) actual or imputed knowledge of the misrepresentation by the party to be estopped; (3) absence of knowledge of facts by the party in whose favor estoppel is applied; (4) intention or expectation of the party to be estopped that the representation or concealment will be acted upon by the other party; (5) reliance by the party seeking the estoppel; and (6) detriment to the party seeking the estoppel

resulting from that party's reliance. ***Sangers Home for Chronic Patients v. Commissioner***, 72 T.C. 105, 115 (1979).

The duty of consistency, as originally suggested in ***R.H. Stearns Co. v. United States***, 291 U.S. 54 (1934), prevents a taxpayer, who has gained a government benefit on the basis of his representation or asserted position, from taking a contrary position in an effort to escape taxes. The doctrine as applied in recent appellate decisions does not require the prior representation made by the taxpayer to be an intentional falsehood, or a wrongful misleading silence, as required for equitable estoppel. ***LeFever v. Commissioner***, 100 F.3d 13, 16-18 (1st Cir. 1996); ***Lewis v. Commissioner***, 18 F.3d 20, 26 (1st Cir. 1994); ***Herrington v. Commissioner***, 854 F.2d 755, 758 (8th Cir. 1988). All that need be established is that the taxpayer has made a representation or reported an item for tax purposes in one year; the Commissioner has acquiesced in, or relied on that fact; and that the taxpayer wants to change his representation after the statute of limitations has run on the initial year in such a way as to harm the Commissioner. **See** ***Unvert v. Commissioner***, 72 T.C. 807, 815 (1979); ***aff'd***, 656 F.2d 483 (9th Cir. 1981), ***cert. denied***, 456 U.S. 961 (1982). When these requirements are met, "the Commissioner may act as if the previous representation on which he relied, continued to be true, even if it is not." ***Eagen v. United States***, 80 F.3d 13, 17 (1996).

Bartel v. Commissioner, 54 T.C. 25 (1970), illustrates how the duty of consistency may be used by the Service in a case involving shareholder loans. The taxpayer in ***Bartel*** was the sole shareholder of a corporation that was liquidated in 1964. During the 11 years preceding the liquidation, the taxpayer received disbursements from the corporation, which he treated as loans for income tax purposes. At the time of liquidation, taxpayer attempted to avoid paying tax on the gain recognized from the corporation's cancellation of his indebtedness, by representing that the prior disbursements were in fact compensation and dividends, not loans. The Tax Court held taxpayer was required to continue treating the disbursements as loans, consistent with their having been treated as loans in earlier years.

REASONABLE COMPENSATION CONSIDERATIONS (S-CORPORATIONS)

If the entity making the advances is an S corporation, before determining whether the debt is bona fide, it must be determined: Did the S corporation reasonably compensate the shareholder who received the advances? If not, the examining agent must evaluate whether all or part of the advances should be reclassified as compensation, subject to employment taxes. The examiner has to determine and substantiate the amount of reasonable shareholder compensation. Any reclassification of advances to wages will create an employment tax issue. If there is more than one shareholder, it may also create an income tax adjustment for the shareholders.

If there are remaining advances after the reclassification to wages, then it must be determined whether the remaining debt is bona fide. The following discussion only deals with the remaining advances made by an S corporation.

Taxability of S Corporation Distributions

Once it is determined that the excess advances are not bona fide, they are, by definition, a distribution to the shareholder. The next step is to determine the taxability of the distribution. The taxability of a distribution depends on whether the S corporation has earnings and profits (E&P) from either prior C corporation operation or from a merger with a C corporation. If there is no E&P, a distribution is taxable as a capital gain if it exceeds the recipient shareholder's stock basis. Be aware of the new stock basis ordering rules that became effective in 1997.

If there is C corporation E&P, the taxability of a distribution depends on the Accumulated Adjustments Account (AAA). The AAA is a corporate level account and is not allocated to any one shareholder. If the distribution is less than the AAA, none of the distribution is taxable as an ordinary dividend, but the distribution must still be compared to the recipient shareholder's stock basis. If the distribution exceeds the AAA, any excess is taxed as an ordinary dividend to the recipient shareholder up to the amount of the E&P. Also, the amount of distribution out of the AAA must still be compared to the recipient shareholder's stock basis. Be aware of the new AAA ordering rules that became effective in 1997. Questions dealing with the taxability of a distribution should be directed to the S Corporation Technical Advisor.

Note: There are slightly different rules if the S corporation has previously taxed income (PTI) from S corporation years prior to 1983, but PTI is now very rare.

Forgiveness of Indebtedness

If a shareholder and corporation initially entered into a bona fide loan agreement, but at a later date decided not to honor the loan, there is a forgiveness of indebtedness issue. Assuming adequate earnings and profits, the shareholder could recognize dividend income to the extent of the indebtedness under IRC section 301(a). **See** section 1.301-1(m) of the Income Tax Regulations.

Distribution with Respect to Stock

If the entity making the non bona fide debt distribution meets the final criteria discussed above or is a C corporation, the examining agent must determine if the distribution was made with respect to stock within the meaning of IRC section 301(a). If the distribution was not made with respect to stock the compensation issue should be explored.

Earnings and Profits Considerations

If the distribution was made with respect to stock within the meaning of section 301(a), the next assessment to be made is whether the corporation has current or accumulated earnings and profits that equal or exceed the distribution in question. If

so, the current year distribution is a dividend. If not, then to the extent of the shareholder's basis in its stock in the corporation, the distribution is a tax-free return of capital. Any portion of the distribution that exceeds the shareholder's basis is taxed as capital gain.

Chapter 2

Bona Fide Debt (Mechanics of)

BELOW MARKET LOANS

In General

IRC section 7872 characterizes a below-market loan (a loan in which the interest rate charged is less than the applicable Federal rate) as two transactions. First, the lender is treated as making a loan to the borrower, requiring the payment of interest at the applicable Federal rate. Second, there is an imputed transfer of funds from the lender to the borrower in an amount sufficient to fund the payment of the interest by the borrower. The imputed transfer from the lender to the borrower is characterized in accordance with the substance of the transaction (e.g., as a gift, compensation, dividend, etc.).

IRC section 7872 generally does not impute interest on loans that require the payment of interest at the applicable Federal rate, as defined in IRC section 1274(d). **See** section 1.7872-3(a) and (b) of the proposed regulations. If the loan document requires interest to be paid or accrued at a stated rate that is at least equal to the applicable Federal rate, IRC section 7872 generally does not apply. **But see** section 1.7872-11(a) of the proposed regulations concerning special rules for waiver, cancellation or forgiveness of interest payments.

If the loan's stated interest is adequate but interest is not being paid or accrued at least annually, interest may be imputed to the lender under the original issue discount rules (sections 1271 - 1275). This is a very important point and is crucial for understanding the application of IRC sections 1272 and 1273 discussed later.

Loans

Congress intended a loan for purposes of IRC section 7872 to consist of [a]ny transfer of money that provides the transferor with a right to repayment ***, "[F]or example, advances on deposits of all kinds may be treated as loans." H.R. Conf. Rep. No. 861, 98th Cong. 2d Sess. 1018 (1984), 1984-3 (Vol. 2) C.B. 272. **See also** ***KTA-Tator v. Commissioner***, 108 T.C. 100 (1997).

Section 1.7872-2(a)(1) of the proposed regulations provides that the term loan is to be interpreted broadly. That section provides that for purposes of section 7872, the term "loan" includes generally any extension of credit…and any transaction under which the owner of money permits another person to use the money for a period of time after which the money is to be transferred to the owner or applied according to an express or implied agreement with the owner.

Before proceeding with development of the issue, it should be determined whether the loan is a demand or term loan.

Demand Loan Defined

IRC section 7872(f)(5) defines a demand loan as:

1. A loan that is payable in full at any time on the demand of the lender; or ,
2. To the extent defined by the regulations, a loan with an indefinite maturity.

IRC section 7872(f)(5) also treats certain compensation-related term loans as demand loans for certain purposes. If the benefits of the interest arrangements of the loan are nontransferable and are conditioned on the future performance of substantial services by an individual, the loan will be treated as a demand loan (for certain purposes; the applicable Federal rate is still dependent on the loan's term). This is important for determinations on loans to shareholders only if the loan is also compensation-related, i.e., the shareholder is also an employee of the lending corporation. No regulations have been issued regarding the treatment of loans with indefinite maturities as demand loans. For more on this issue, however, see ***KTA-Tator, supra***; ***Mason v. Commissioner***, T.C.M. 1997-352.

Term Loan Defined

IRC section 7872(f)(6) defines a term loan as any loan that is not a demand loan. **See also** section 1.7872-10(a) of the proposed regulations.

After a determination has been made regarding the applicability of IRC section 1274 and the type of loan (i.e., term or demand), the agent will make a determination as to whether the loan is a below-market loan.

Applicable Federal Rates

Determining the applicable Federal rate ("AFR") under the guidance of section 1.7872-3 of the proposed regulations, particularly with a demand loan, is not an easy task. This is because a loan balance can fluctuate throughout a tax year, the applicable Federal rates are continually changing, and the law is intricate in its application.

Section 1.7872-3(b)(2) of the proposed regulations establishes that the AFR is defined by reference to "Federal statutory rates" and "alternate Federal rates." However, the AFR has evolved since these regulations were first proposed. This has, to some degree, made the application of section 1.7872-3 of the proposed regulations confusing. The problem is that these rates no longer exist as they did in 1984. An understanding of the history may eliminate some of the confusion.

The Federal statutory rate was a semiannual interest rate, computed using the average of market yields of U.S. securities. Because AFRs were not published often enough, the Internal Revenue Service ("the Service") decided to compute them on a monthly basis. The monthly interest rate is referred to by the proposed regulations as the "alternate Federal rate," and is based on average yields of U.S. securities on a 1-month basis, instead of on a 6-month basis. In an amendment to IRC section 1274, the alternate Federal rate was adopted as the standard for the applicable Federal rate. The statutory Federal rate is no longer separately published, although it remains a benchmark within the proposed regulations for IRC section 7872.

The bottom line is that we will apply the AFRs that are issued monthly in the Internal Revenue Bulletin (first issue of each month). The purpose for this discussion will be clarified in the following analysis.

IDENTIFICATION

Identifying a Below-Market Demand Loan

Section 1.7872-3(b)(3)(i) of the proposed regulations states: "In the case of a demand loan, the AFR for a semiannual period (January 1 through June 30 or July 1 through December 31), is the lower of:

(A) The Federal statutory short term rate in effect for the semiannual period; or,
(B) The special rate for demand loans described in paragraph (b)(3)(ii) of this section."

In short, the proposed regulation provides that the rate of interest which will be referenced for demand loans is the lower of the monthly rate for short term loans that is in effect on the day that the loan is entered into, or the semiannual rate for short term loans in effect for the first month of the semiannual period (i.e., January or July). The latter of the two will effectuate the former federal statutory rate test until the regulations are clarified.

The regulations discuss two different interest rates: the "Federal statutory rates" found in section 1.7872-3(b)(3)(i)(A) of the proposed regulations and the "alternate Federal short term rate" found in sections 1.7872-3(b)(3)(ii) (A) and (B) of the proposed regulations. As discussed above, when these regulations were proposed, there was a difference between the two rates of interest. Now there is no difference. An agent will only reference the applicable Federal rates issued monthly in the Internal Revenue Bulletin.

To illustrate application of the rules in section 1.7872-3(b)(3) of the proposed regulations, assume the following facts: A corporation lends a shareholder $100,000 on March 3. The loan is a demand loan with a stated rate of interest of 6 percent compounded semiannually. The short-term rate for January (assuming semiannual compounding) is 5.5 percent and the short-term rate for March is 6.1 percent. The loan is not below market because the lower of the January and March rates is 5.5 percent, which is less than the loan's stated rate. In July, however, the loan must be re-tested. This is discussed further below.

If the corporation changes the stated interest rate at any time, it is considered a new loan, and one must refer once again to the rules of section 1.7872-3(b)(3) of the proposed regulations.

For audit purposes, this is important. To illustrate, assume that a loan was made to a shareholder in May of 199x at a stated rate of 5 percent. At that time, assume that the loan met the test in section 1.7872-3 of the proposed regulations, and thus was determined not to be below market. Now, assume you are auditing the subsequent year’s return and the loan remains at the same rate of 5 percent. Assume further that the interest rates for the two semiannual periods in the subsequent year rise to 7 percent and 7.5 percent, respectively. Per section 1.7872-3 of the proposed regulations, the loan is now a below-market loan. This example illustrates that the corporation or shareholder must continue to monitor the applicable Federal rates when it has a demand loan.

Section 1.7872-3(c) of the proposed regulations states that: "7872 does not apply to any loan which has sufficient stated interest. A loan has sufficient stated interest if it provides for interest on the outstanding loan balance at a rate no lower than the applicable Federal rate based on a compounding period appropriate for that loan."

Thus, to determine the status of a demand loan for purposes of section 7872, apply the following test, summarized as follows:

1. On the day the loan is made, the stated short-term rate of interest must be at least equal the lower of the AFR for the semiannual period (i.e., the January or July rate) in which the loan is made or the short term AFR for the month in which the loan is made (if made in a month other than January or July), compounded at the payment or compounding interval stated in the loan. This test will only apply to the first period of a new loan or when interest is restated on an existing loan; or

2. The stated rate must be at least equal to the AFR for short-term loans compounded at the compounding interval or payment interval stated in the loan or interval for semiannual compounding, whichever is shorter, for the semiannual period, beginning in either January July. This is the semiannual interest rate for short-term loans for the month of January or July, whichever is applicable. This will effectuate the former test for the federal statutory rate; or

3. For demand loans that are outstanding the entire calendar year, the stated rate based on semiannual compounding at least equals the blended annual rate. The blended annual rate is based on semiannual rates published in January and July of the calendar year, and is published with the July AFRs.

When the AFRs are increasing, the revenue agent should verify that the corporation is making the proper adjustments to an existing loan. For further information concerning the rules for variable rate demand loans, **see** section 7872-3(e) of the proposed regulations.

Identifying a Below-Market Term Loan

The rules for determining whether a term loan is below market are considerably less complicated. Section 7872(f)(2) of the Code and section 1.7872-3(b)(4) of the proposed regulations state that the AFR is the one in effect on the day that the parties enter into the loan. For application of the AFR, the length of the term, compounding period and stated rate of interest must be considered. A below-market term loan is one with a stated rate of interest that is below the AFR as of the day the loan was entered into. Subsequent fluctuations in the AFR will not affect the status of the loan.

Unlike a demand loan, which references to short-term rates, the term loan may reference to short-term, mid-term, or long-term rates depending on the loan's term. IRC section 1274(d)(1)(A) provides that in the case of a loan with a term of less than 3 years, the AFR is the Federal short-term rate. If a loan’s term is more than 3 years, but not more than 9, the AFR is the Federal mid-term rate; while the

AFR is the Federal long-term rate if the loan is more than 9 years. An exception to the general rule exists when the loan provides for variable rates of interest. In such cases, section 1.7872-3(e)(2)(ii) of the proposed regulations provides that the length of the term will be treated as being equal to the longest period of time that exists between the dates that, under the loan agreement, the interest rate charged on the loans is required to be recomputed. When referencing the AFR tables, use the compounding interval consistent with the stated compounding or payment interval in the note (i.e. monthly, quarterly, semiannually, etc.).

If the corporation reduces the interest rate on a term loan during the term of the loan, there may be an IRC section 1001 issue. The agent may wish to request that the appropriate district counsel office contact the National Office for assistance on cases that involve this issue of whether a "significant modification of a debt instrument," within the meaning of the regulations under IRC section 1001 is a realization event. **See also** section 1.1001-3 of the Treasury Regulations.

EXCEPTIONS

De Minimis Exception

Under IRC section 7872(c)(3), the rules of IRC section 7872 do not apply to any corporation-shareholder loan so long as: 1) the loan is not a tax avoidance loan; and 2) the aggregate amount of loans (below and at or above market) outstanding between the lender and the borrower does not exceed $10,000.

Other Exceptions

When a Loan is not a "Loan" for Purposes of IRC section 7872

"Generally, [IRC] section 7872 does not apply to any loan which is given in consideration for the sale or exchange of property (within the meaning of [IRC] section 1274(c)(1)) or paid on account of the sale or exchange of property (within the meaning of [IRC] section 483(c)(1) ***." **See** section 7872(f)(8) of the Code and section 1.7872-2(a)(2)(ii) of the proposed Income Tax Regulations.

Loans that are made in connection with the sale or exchange of property are generally governed by IRC section 483 or IRC section 1274. Other loans fall under IRC sections 482, 1272, and 7872.

Certain Loans Given in Exchange for Property Subject to IRC section 7872 and not IRC sections 483 and 1274

Section 1.7872-2(a)(2)(ii) of the proposed regulations provides that generally IRC section 7872 does not apply to any loan which is given in consideration for the sale or exchange of property (within the meaning of IRC section 1274(c)(1)) or paid on account of the sale or exchange of property (within the meaning of IRC section 483(c)(1)), even if the rules of those sections do not apply by reason of exceptions or safe harbor provisions. Any transaction, however, which otherwise is described in IRC section 7872(c)(1)(A), (B), or (C) (gift loan, compensation loan, or shareholder loan) and is

1. A debt instrument that is issued in exchange for property and that is payable on demand;

2. A debt instrument described in section 1273(b)(3)(debt instruments issued for publicly traded property), or

3. A debt instrument described in section 1275(b), dealing with debt instruments issued for personal used property), unless the transaction is described in an exception in Treas. Reg. section 1.7872-5T(b)(1),

is not subject to IRC sections 483 and 1274 and is subject to IRC section 7872.

Of the exceptions noted above, the first exception applies most often in the shareholder loan context. If a gift, compensation-related, or corporation-shareholder loan is made in connection with the sale or exchange of property, and it is a demand loan, IRC section 7872 will still govern.

For example, assume that a corporation enters into a sale- leaseback arrangement with its 100 percent shareholder. If the shareholder finances the purchase by borrowing from the corporation at a below market rate, IRC section 7872 applies if the loan to the shareholder is payable on demand.

Exempted Loans

IRC section 7872 does not apply to loans described in section 1.7872-5T(b) of the regulations because the interest arrangements of these loans do not have a significant effect on the Federal tax liability of the borrower or the lender.

COMPUTATIONS

Computation of Forgone Interest in a Below-Market Demand Loan

The first rule to keep in mind while computing the forgone interest is that the imputed transfers under IRC section 7872 are deemed to be transferred and retransferred on December 31. **See** section 7872(a)(2) of the Code.

"Forgone interest" is the difference between the amount of interest that would have been payable on a loan for the period in which it was outstanding if interest had accrued at the AFR and the interest payable on the loan per the loan's stated rate. These two interest amounts are analyzed in the following paragraphs.

The amount of interest that would have been payable had it accrued at AFR is determined by using the applicable federal rate. If the principal balance is outstanding for the entire year, the computation is simple. The computation becomes more difficult if the loan was entered into during the year, or if the balance increases or decreases.

Balance Outstanding for the Entire Year

For a demand loan with a balance outstanding for an entire year, the "blended annual rate" may be applied to the loan balance. **See** section 1.7872-13(a) of the proposed regulations. The blended annual rate is a combination of the interest rates for the two semiannual periods during the year under examination and is published each July.

The second part of the computation is the interest that is payable under the terms of the loan. That is the interest that is properly allocable to the year under examination, as computed under the stated interest rates and compounding interval. It does not necessarily equal the amount included in income by the lender. If the lender has incorrectly recognized interest income, the agent will use the loan's stated terms. The difference between the amount that should have been allocated to the year under examination and the amount reported will be adjusted separately.

The computation of forgone interest for a demand loan is illustrated as follows:

Example 1

A $300,000 demand loan is made to a shareholder in year 1990. The year under examination is 1994. The loan's stated rate of interest is zero percent. As the loan is outstanding for all of 1994, the blended annual rate will be used to compute the loan's forgone interest. Assuming the blended annual rate is 6 percent, the amount allocable at AFR is $18,000. Per the terms of the note, the amount allocable per the term is $0. Thus, the adjustments in 1994 will include an $18,000 dividend (assuming adequate E&P) to the shareholder and $18,000 in interest income reportable by the corporation. The shareholder may also be entitled to deduct the forgone interest as deemed paid to the corporation. This deemed exchange occurs on December 31, 1994, when the corporation is deemed to have distributed $18,000 to the shareholder to fund the shareholder's interest payment.

Short Period Computations

Not all loans are entered into or outstanding on January 1, and loan balances frequently increase or decrease. As noted above, incremental increases are considered new loans under IRC section 7872. Thus, there are frequently short period interest computations that are necessary.

There are two methods discussed in section 1.7872-12 of the proposed regulations. These two methods are the exact method and the approximate method. Basically, where the loan to a shareholder has an aggregate balance of less than $250,000, the taxpayer may use the approximate method.

These methods are illustrated with the following facts: A loan is made on March 1, 1990, and is outstanding for the remainder of the year. Assume the applicable Federal rate (using the rules previously discussed) is 10 percent, compounded semiannually. The interest for a full semiannual period would be 5 percent (10 percent divided by 2, or 5 percent for each semiannual period). However, we do not have a full semiannual period. Thus, the interest must be allocated to the days in which the loan is outstanding. That is done in one of the following ways:

1. Approximate Method: Using a 30-day month convention, a percentage is computed wherein the numerator is the number of days in the short period and the denominator is 180. In the example above, the interest properly allocable to the short period at AFR is computed by multiplying the loan amount by 5 percent and then multiplying that amount by 66 percent (120/180). Assuming that the AFR did not change for the second semiannual period, the short periodic interest

would be added to the product of 5 percent multiplied by the loan balance. This would equal the total interest allocable to the year under exam at AFR.

2. Exact Method: Under the exact method, the steps are the same, except the percentage that is computed is not simply computed by dividing the number of days in the short period by 180. The exact method formula is as follows:

$$[(1+.10/2)^{f} - 1]$$

The exponent f in the formula is the fraction of the number of days in the short period divided by 180. The resulting percentage is multiplied by the loan balance to arrive at the amount of interest allocable to the first semiannual period.

Loans with Increasing Balances

The short period interest computations are not only important for periods in which a loan is first entered into. The rules are also used for increasing and decreasing loan balances. To compute the interest that accrues at the AFR on a demand loan with increasing loan balances, the following steps should be followed:

1. Isolate the part of the loan that is outstanding for the entire year. Apply the blended annual rate to that part.

2. Isolate the timing and amounts of increases to the loan throughout the year. For loans that are constantly increasing, the increments should be isolated on a monthly basis.

3. Compute the short-period interest for each increment using the AFR. If the loan balance exceeds $250,000, the exact method is to be employed, as discussed above.

4. Add the interest amounts as computed in step one and step three, and subtract the interest that is allocable to the year based on the stated rate of interest.

Loans with Decreasing Balances

With one additional rule, the technique is the same for computing the forgone interest on loans with decreasing balances. The additional rule is found in section 1.7872-13(c) of the proposed regulations which provides that any payment will first be applied to the unpaid stated interest, and then to

principal. Thus, the only time that a payment on a loan will affect the computation of forgone interest is if it reduces the principal. The following steps should be followed in computing forgone interest on a demand loan with decreasing balances:

1. Compute the interest on the loan at its initial balance, less all reductions to principal for the entire year. (For example, loan balance at January 1 was $100,000. If a payment of $40,000 was made on September 1, the interest on $60,000 would be computed for the entire year.)

2. Compute the interest on the decrement for the period up to the day it was paid (e.g. interest at the AFR on $40,000 for the period January 1 through September 1.)

3. Add the interest computed in step one to the interest computed in step two. That will equal the amount of interest computed at AFR. Subtract the amount of interest allocable to the period at the stated rate. The sum will equal the foregone interest for the year.

Please refer to section 1.7872-13(d) of the proposed regulations for a complete analysis and computations of a below-market demand loan with increments and decrements illustrated.

The Computation of the Imputed Transfer and Original Issue Discount in a Below-Market Term Loan

Section 1.7872-7 of the proposed regulations prescribes the timing and amount of transfers in connection with a below-market term loan. There are two elements of a deemed transfer arising out of a below-market term loan that, for conceptual purposes, require initial discussion.

First, the deemed transfer from the lender to the borrower occurs the day that the loan is entered into. That is unlike a demand loan for which the deemed transfers occur on December 31 of each year. The implications are obvious. If a revenue agent is auditing a timely filed return that has a four-year-old below-market corporation-shareholder term loan, then the deemed transfer occurred in a closed year. Thus, the agent may not make adjustments for the IRC section 301 distribution resulting from the deemed transfer.

Section 1.7872-14 of the proposed regulations provides rules for computing the present value of a payment to be made in the future. When the amount loaned exceeds the present value of all payments due under the term loan, discounted at the appropriate AFR, the loan is below market. The excess amount, or “imputed transfer,” is treated as transferred by the lender to the borrower on the date of the loan. The borrower is treated as paying interest

equal to the imputed transfer back to the lender on an economic accrual basis (as original issue discount) over the term of the loan.

There are two areas that potentially generate audit adjustments for a below-market term loan: 1) the initial deemed transfer will produce dividend income to the shareholder; and 2) the corporation will recognize imputed interest income as original issue discount generated in the deemed exchange. Over the term of the loan, the amount of OID will equal the imputed transfer, which was a dividend to the shareholder. (**Note** if the shareholder is the lender, the imputed transfer will result in interest income to the shareholder and a capital contribution to the corporation.)

The corporation must recognize qualified periodic interest and/or OID that is computed under IRC sections 1272 and 1273 on an economic accrual basis over the term of the loan. IRC sections 1272 and 1273 generally require interest to be recognized on a constant yield regardless of the lender's accounting method. If the lender is on the cash method, the original issue discount rules of IRC sections 1272 and 1273 force them onto the economic accrual method of accounting for the interest earned on the loan for a given period. This is a method of accounting and as such would be subject to the guidance provided in Rev. Proc. 97-27, 1997-1 C.B. 680 (effective for accounting method changes filed on or after May 15, 1997). Refer to Appendix A of this section for a complete example, with computations to be made for an Excel spreadsheet.

Example 2

On January 1, 1988, A (corporation) loans B (shareholder) $100,000 in exchange for a $105,000 note bearing interest below AFR. Assume the present value of all payments is $85,000 (with a discount rate equal to the required AFR). On January 1, 1988, A will be treated as having distributed $15,000 to B so that B could make the deemed interest payments. The original issue discount for this loan is equal to $15,000 imputed under section 7872, plus $5,000 other OID. The $20,000 will be included in the income of A on an economic accrual basis over the term of the loan under IRC section 1272. B will recognize the $15,000 dividend in 1988 the date the loan is made. Furthermore, assuming that interest on the loan would be otherwise deductible if actually paid by B, B will be allowed to deduct the OID, under IRC section 163(e), as computed under IRC section 1272. Thus, over the term of the loan, A will recognize, and will be treated as paying, interest ($20,000) on an economic accrual basis regardless of the respective accounting methods of A or B.

Example 3

Assume the same facts, except that the agent is auditing A’s 1994 Form 1120. In this example the corporation is a cash basis taxpayer that believed it did not have to recognize any interest income until payment was made in year 10. In such a case, the agent is precluded from adjusting the Form 1040 for the dividend in year 1988. However, under

IRC sections 1272 and 1273, the taxpayer should have been economically accruing the OID on the debt instrument. The taxpayer will now be subject to an accounting change. **See** Rev. Proc. 97-27, 1997-1 C.B. 680.

INTEREST ISSUES ON MARKET RATE LOANS

Demand Loans with Stated Interest at or above AFR

If the demand loan is not below market based on the terms of the note, there generally will be no dividend to the shareholder. However, the terms of the loan should be analyzed to determine if the corporation is properly recognizing the interest that is allocable to the period. The rule of thumb is that where there is a loan, there must be interest income at an arm's length rate recognized on a yearly basis, regardless of the corporation's method of accounting. Even if the corporation is on a cash basis, IRC section 1272 requires it to recognize the interest annually. If not, this may be a change in the method of accounting, resulting in an adjustment for all prior years' unrecognized interest income in the year under examination. The original issue discount rules can apply to demand loans. **See** section 1.1272-1(d) of the proposed regulations.

Refer to Appendix B for a complete workpaper format analysis of the application of the regulations at sections 1.1272 and 1.1273. If interest is not being paid on the loan per the terms of the loan, section 1.7872-11 of the proposed regulations should also be considered. The following discussion will analyze this in more detail. If the taxpayer requests the change during an appropriate window under Rev. Proc. 92-27. 1997-1 C.B. 680, a spreading of the adjustment may be available to the taxpayer.

Market Rate Term Loans

If the term loan is not a below-market term loan, as previously discussed, the rules of IRC sections 1272 and 1273 may still apply. Regardless of the taxpayer's accounting method, it must include the original issue discount (interest) in income on the economic accrual basis. Those rules require at least a semiannual compounding accrual period. The rules effectuate an inclusion of interest income on a semiannual basis with the time value of money concept. Thus, in the early years of the term, more OID will be includable than in the later years on a yearly basis.

Example 4

A shareholder enters into a 20-year term loan with a corporation with all interest and principal due from the shareholder at the end of the term (year 20). The loan is not a below market loan because the required interest rate was equal to the AFR on the day it was entered into. The corporation and the shareholder are cash basis taxpayers. IRC section 1272 will require the corporation to include interest income yearly as it "economically accrues," per the original issue discount rules. In effect, all taxpayers are accrual when it comes to the recognition of interest income. Refer to Appendix B for a complete workpaper format analysis of economic accrual.

The phrasing of IRC sections 1272 and 1273 could lead a taxpayer to conclude that, by the nature of the way that OID is computed, it is not subject to an accounting change. The Code refers to issue price, adjusted issue price, accrual period, and yield to maturity when discussing computations of OID. The computation is as follows:

1. OID for a given period = the increase in the adjusted issue price.

2. Adjusted issue price = the original issue price plus all previously accrued OID.

3. The adjusted issue price for any given accrual period = the product of adjusted issue price at the beginning of the accrual period and the yield to maturity.

At first glance, one could misinterpret the rules in IRC section 1272. The taxpayer could assume that since no OID has been computed, the adjusted issue price at the beginning of the accrual period is equal to the original issue price. Thus, instead of an accounting change, the inherent computational rules roll the adjustment forward. If the above example were interpreted this way, the OID would be recognized on the economic accrual basis in the last four years. However, the IRC section 1272 reference to interest that increases the adjusted issue price refers to interest which is accured or accruable (the proposed regulations use the term “allocable”). It is analogous to the depreciation concept of allowed or allowable for the recapture rules. Thus, it is a change in accounting method, resulting in an IRC section 481(a) adjustment for all interest that should haven been reported in the prior years.

Waiver or Cancellation of Interest

In addition to making an adjustment at the corporate level for stated but unrecognized interest income, under certain conditions a dividend will be deemed to be distributed from the corporation for the years that are not closed by statute. (That is, a loan with a stated rate at or above AFR may be

treated as a below-market loan under IRC section 7872 if the stated interest is waived). That is achieved by applying section 1.7872-11 of the proposed regulations. That section states that if the loan were to meet all the requirements of IRC section 7872 (had the loan been made with a stated rate at zero percent), and the loan's stated interest (and not a substantial part of the loan's principal) is subsequently waived, cancelled, or forgiven, the loan may be treated as a below-market loan and the unpaid interest may be treated as if it had been paid to and then retransferred by the borrower.

Many taxpayers will include interest in income at the corporate level by making a year-end entry, crediting interest and debiting the loan. Thus, they add the interest receivable to the balance of the loan. In these cases the agent should analyze the additional loan (equal to the interest) based on the previously discussed indicia of a bona fide loan.

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BELOW MARKET TERM LOAN EXAMPLE

Facts: A corporation loans a shareholder $100,000 payable in equal semiannual payments over 3 years at 8 percent. The applicable Federal rate in effect at the inception of the loan is 11 percent. Assume the shareholder adheres to the terms of the loan.

Analysis: The loan is a below market term loan subject to IRC section 7872. The payments of principal and interest per the stated terms of the loan are computed by using the following function in Excel spreadsheet: =PMT (.04,6,100000). This computes the semiannual payment comprised of interest and principal. In the formula, the principal, rate per compounding period, and total number of compounding periods are listed in order in the parenthesis. The loan is amortized as follows:

A	B	C	D	E
Accrual Period	**Principal Balance**	**Payment**	**Interest**	**Principal**
1	$100,000.00	$19,076.19	$4,000.00	$15,076.19
2	84,923.81	19,076.19	3,396.95	15,679.24
3	69,244.57	19,076.19	2,769.78	16,306.41
4	52,938.17	19,076.19	2,117.53	16,958.66
5	35,979.50	19,076.19	1,439.18	17,637.01
6	18,342.49	19,076.19	733.70	18,342.49
				$ 100,000.00

(A) Compounding periods over the 3-year term.

(B) Balance of principal remaining prior to the payment for the period.

(C) Amount of payment applicable to principal computed by subtracting (D) from (E).

(D) Interest equals the principal balance multiplied by the stated rate. In the above computation this equals 4 percent (or 8 percent compounded semiannually).

(E) The total payment as computed by =PMT(.04,6,100000).

Since the AFR for the loan is 11 percent compounded semiannually, the loan is subject to IRC section 7872. The present value of the semiannual payments at 11 percent compounded semiannually will compute the issue price of the debt instrument. The difference between the issue price and the $100,000 stated value will equal the original issue discount. This is computed in Excel spreadsheet as follows: =PV (.055,6,19076)= $95,296

The following table computes the OID allocable to each period:

A	B	C	D	E
Accrual Period	**Adjusted Issue Price**	**Yield to Maturity**	**Qualified Interest**	**OID**
1	$95,296	$ 5,241	$4,000	1,241
2	81,461	4,480	3,397	1,083
3	66,865	3,678	2,770	908
4	51,467	2,831	2,118	713
5	35,220	1,937	1,439	498
6	18,081	994	734	260
				$ 4,703

(B) Adjusted Issue Price equals Adjusted Issue Price in prior year less principal payment per table above plus OID for prior period.
(C) Yield to maturity equals adjusted issue price at the AFR for the accrual period (11% / 2 = 5.5%).
(D) Qualified Interest equals the interest as payable per the stated terms of the loan allocable to the period.
(E) OID equals yield to maturity less the qualified interest.

Conclusion: Per IRC section 7872, the shareholder will have a dividend of $4,703 on the day the loan is made. Also, depending upon what the shareholder uses the loan for, the shareholder may be entitled to an IRC section 163 interest deduction for amounts of OID deemed paid under IRC section 7872. The corporation will report interest income for years 1 through 3 as follows:

Tax Year	Stated Interest	**OID**	**Total**
1	$7,397	$2,324	$9,721
2	4,888	1,621	6,509
3	2,173	758	2,931

If all 3 years are open for exam, the 3 percent difference between the stated rate and the AFR will result in total combined adjustments to income of $9,406, assuming the shareholder is not entitled to deductions for OID.

BELOW MARKET DEMAND LOAN EXAMPLE

FACTS: A corporation's balance sheet reports a zero-interest loan to shareholder with a beginning balance of $100,000 and an ending balance of $130,000. Per the examination of the books and records, it is determined that the following activity occurred within the loan account:

1) The loan balance increased to $140,000 on February 1;
2) The loan balance decreased by $10,000 on November 1.

As result of additional requests, the shareholder provides a loan document consisting of an entry in the corporate minutes that states:

> "The 100 percent shareholder may from time to time borrow money from the corporation in any amounts not to exceed a total balance of $200,000. The loan is payable on demand without interest. If this note is placed in the hands of an attorney for collection, the shareholder agrees to pay the corporation's reasonable attorney's fees."

ANALYSIS: Per section 1.7872-3 of the proposed regulations, the Revenue Agent has determined that the AFR for the semiannual period starting January 1 and the AFR for the semiannual period starting July 1 are 6 percent and 8 percent, respectively. Also, the agent determined that the blended annual rate for the year is 7.5 percent. The interest is computed in steps as follows:

1) Compute the interest on the loan balance of $100,000 for the period January 1 through December 31. This will be done using the blended annual rate.

2) Compute interest on the loan of $40,000 from February 1 through June 30 using the "approximate method" at 6 percent.

3) Compute interest on $30,000 from July 1 to December 31 at 8 percent.

4) Compute interest on $10,000 from July 1 to November 1 using the "approximate method" at 8 percent.

COMPUTATIONS:

1) 1/1____12/31
$100,000 @ 7.5% = $7,500

2) 2/1______________________6/30
$40,000 @ 3% = $1,200
150/180 = 83%
83% X $1,200 = $996

3) 6/30_______________________________12/31
$30,000 @ 4% = $1,200

4) 6/30________________________11/1
$10,000 @ 4% = $400
120/180 = 66%
66% X $400 = $264

Therefore, the forgone interest is $7,500 + $996 + $1,200 + $264 = $9,960.

CONCLUSION: On December 31, the shareholder is deemed to have received dividend distributions of $9,960 and was also deemed to have made an interest payment of $9,960 to the corporation. An adjustment of $9,960 is made to the shareholder and the corporation.

KEY COURT CASES

(Bona Fide Debt vs. Constructive Dividend)

Alterman Foods, Inc v. United States, 505 F.2d. 873 (5th Cir. 1974)

Baird v. Commissioner, 25 T.C. 387 (1955)

Bartel v. Commissioner, 54 T.C. 25 (1970)

***Estate of Chism v. Commissioner*,** 322 F.2d. 956 (9th Cir. 1963)

***Harvey v. Commissioner*,** T.C.M. 1999-54

***KTA-Tator v. Commissioner*,** 108 T.C. 100 (1997)

***Mason v. Commissioner*,** T.C.M. 1997-352

***Pierce v. Commissioner*,** 61 T.C. 424 (1974)

***Roschuni v. Commissioner*,** 29 T.C. 1193 (1958)

***Shea v. Commissioner*,** 83-1 USTC ¶9115 (N.D. Ala. 1982)

***Smith v. Commissioner*,** T.C.M. 1980-15

***Tarrson v. Commissioner*,** 25 T.C.M. 671 (1966)

***Thielking v. Commissioner*,** T.C.M. 1987-227

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